

ANALYSES OF EARNINGS MANAGEMENT PRACTICES IN FIJI'S STATE OWNED ENTERPRISES¹

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ABSTRACT

Earnings management practices lower the quality of financial reporting as they are used to obscure the true performance of businesses. This study analyses earnings management in two statutory organizations in Fiji, the Housing Authority and the Fiji Electricity Authority, over the period 1990 to 2004, using the checklists designed by Mulford and Comiskey (2002). The results seem to indicate that these entities practiced earnings management by using provisions, amortisation and depreciation, revaluation, capitalisations and misclassification of government grants. These practices were largely the result of professional judgment and flexibility permitted by the accounting standards. Further, agency relationships provided several economic incentives to misreport the financial outcome.

Key words: earnings management, state-owned entities, accounting standards, agency theory

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I. INTRODUCTION

International corporate collapses and the demise of Arthur Anderson reflect the failure of conventional accounting and auditing practices and question the integrity of financial reporting. Earnings management practices is one of the many factors that lower the quality of financial reporting. It occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports either to mislead stakeholders about the economic performance of the company or to influence the contractual outcomes that depend on reported accounting numbers (Healy and Wahlen, 1999). Accounting standards allow scope for flexibility and judgment in preparing financial reports. Healy and Wahlen argue that accounting standards must allow these so that management can convey information to the stakeholders about the entity's performances. Nonetheless, they also acknowledge that such flexibility can also create opportunities for earnings management.

Brewer *et al.* (2002), Healy and Wahlen (1999) and Blake *et al.* (1998) discuss several potential areas for earnings management resulting from the accounting standards. Based on their studies, these can be grouped into five categories. Firstly, management exercises judgment in order to estimate several future economic events, such as, the expected lives and salvage values of long-term assets, obligations for pension benefits and other post employment benefits and losses from bad debts and asset impairment. Secondly, managers can report the same transactions using a range of acceptable accounting methods, for instance, depreciation and inventory valuation methods. Thirdly, management exercise judgment when evaluating whether a transaction meets the criteria for a particular accounting treatment. For example, the treatment of borrowing costs as an asset or an expense. Fourthly, management can decide the timing of genuine transactions, such as research and development, advertising or maintenance, in order to give the desired impression. Lastly, management can choose how to structure corporate transactions so that the financial statements can be manipulated. For example, equity investments can be structured to avoid or require consolidation.

Agency theory provides a framework for understanding earnings management as it provides agents with economic incentives to manipulate the financial results. Several economic incentives are described in the literature, such as managerial compensation (Healy;1985, Gaver *et al.* ;1995 and Guidry *et al.* ;1999), borrowing costs (DeFond and Jiambalvo;1994 Sweeney 1994 Dichev and Skinner 2002), equity offerings (Teoh *et al.* ;1998a Rangan 1998 and Teoh *et al.*1998b), management buyout (DeAngelo 1986, Perry and William 1994) and regulatory considerations (Jones 1991 and Cahan 1992). Managers face a wide variety of financial reporting situations in the real world and a correspondingly wide variety of opportunities and methods to misreport the financial performance of their organisations.

The issue of earnings management has been widely researched and found to be pervasive in the private sector in many developed economies. However, little work has been done in the context of developing economies and the public sector. This paper aims to identify and analyse instances

of earnings management in the public sector of a developing economy, Fiji. The study focuses on two State Owned Enterprises (SOEs) - the Housing Authority and the Fiji Electricity Authority. Fiji is no exception when it comes to failures in financial reporting. An excellent example is the economic losses incurred when the National Bank of Fiji (NBF) collapsed. Grynberg *et al.* (2002) describe the NBF's case as the 'largest known financial scandal in the history of Fiji and the Pacific Islands'. According to them, the bank's failure resulted from corruption, mismanagement and improper accounting practices. Its failure emphasised the need for good financial disclosures, sound corporate governance and robust banking supervision.

II. EARNINGS MANAGEMENT IN STATE OWNED ENTITIES

SOEs are an essential part of Fiji's economic environment as many of the largest organisations in Fiji are state owned. These entities are large consumers and producers of resources in Fiji's economy hence provide essential products and services. This study concentrates on SOEs that are fully owned by the government. These entities are administered by the Ministry of Public Enterprises and Public Sector Reform, which monitors compliance with the financial reporting and disclosure requirements of the *Public Enterprise Act 1996*. The government provides equity and debt finance to SOEs but receives returns only from the profitable ones. As of 2002, the government required the SOEs to achieve a 10% benchmark required rate of return on shareholders funds, which is used as a financial performance indicator for successfully operating SOEs. Government also provides substantial amount of grants to SOEs and are often required to act as guarantor for SOEs' debts. These entities are vulnerable to earnings management due to the economic incentives, accounting regulation and cultural factors as discussed below.

While the literature discussed several economic incentives in the private sector, the following section aims to relate those incentives to the SOEs in Fiji. Management compensation is one of the common incentives in the private organizations but is not highly prevalent in the public entities. However, in order to improve performance, some SOEs, such as the Housing Authority, have implemented performance based contracts. Therefore, the executive management of these entities have incentives for earnings management. Further, the extent of the borrowing cost incentive in the public sector is not very clear. No doubt, SOEs require large amount of debt finance from the local as well as international lending agencies, which would impose certain debt covenants. These entities may not worry if they violate the covenants as in most cases the loans are government guaranteed. Alternatively, the government as the guarantor of debts may exert pressure on them to meet the covenants. Therefore, it is not clear if the borrowing cost would provide an incentive to the SOEs for earnings management. The incentive that is highly relevant to Fiji's SOEs is that of reducing (increasing) regulatory cost (benefit). As these enterprises rely heavily on government assistance, it is expected that they would be inclined to report conservative earnings in order qualify. Supporting this argument Pathik (1999) finds that in the year the government was planning to withdraw their financial assistance, the Housing Authority misclassified government grant in its financial reports and managed to report lower earnings. It feared that large profit would provide the needed rationale to the government to withdraw their assistance. This is an example of a SOE reporting conservative earnings in order to continue

receiving government grants. In addition to its financial objectives, SOEs also have social obligations. Social objectives would provide incentives to report conservative earnings, as reporting higher than average profits would instigate a public scrutiny. Apart from these general incentives, there could be other entity-specific incentives, which would be known by investigating the individual organizations.

The Fiji Institute of Accountants (FIA) issues Fiji Accounting Standards (FASs) that serve as the basis for preparing financial statements. The FASs are almost entirely based on International Accounting Standards (IASs), which provides flexibility in financial reporting. IASs are developed mainly on the basis of accounting standards that prevail in the developed countries of the UK and USA. Therefore, if the IAS or equivalent in these countries provided opportunities to manage earnings then the use of the same standards is also likely to enable such behaviour in adopting countries, like Fiji. The FIA is responsible for monitoring compliance with the accounting standards. However, so far there has been minimal effort to enforce compliance. Earnings management practices mainly occur within the boundaries of accounting standards so if the FIA is weak in monitoring compliance, it would be weaker in detecting manipulations. This provides additional opportunities for earnings management in Fiji. Barton and Simko (2002) argue that although accounting standards require managers to make numerous judgments and assumptions to report firm performance, managers do not have unlimited discretion to do so. The accounting regulators and professional bodies such as the Securities and Exchange Commission, the Financial Accounting Standards Boards and the American Institute of Certified Public Accountants, provide rigorous guidelines and oversight. On the contrary, Fiji does not have such bodies to limit managers' use of discretion. This suggests that there is even higher scope for earnings management in Fiji.

Cultural factors could also impact on the presence of earnings management. Countries can be differentiated on the basis of the cultural dimensions identified by Hofstede (1980). Although these dimensions are diminishing, Chand (2003) argues that there exist cultural differences between Fiji and the developed countries. The dimension that differentiates Fiji from the developed countries and has implications for earnings management is power distance. Relative to the countries like the UK and USA, Fiji is considered to be a large power distance society. This implies that the Fijian society accepts the hierarchical order in which everybody has a place and they do not require justification. Thus, the management knows that their financial reports would be accepted as given without questioning. Hence, the cultural value of large power distance reduces the chances of detecting any creative accounting practices. Similarly, Chand and White (2006) argue that in general Fiji exhibits large power distance. However, contrary to their expectation, they found that accountants are comfortable in making judgments. Their results are surprising as it is not a consistent behaviour given a range of cultural factors. Nonetheless, they suggest that the accounting community is 'accultured'. That is, it has its own professional culture rather than the culture of the various ethnic groups they are drawn from. There is, therefore, a possibility that instances of earnings management will not be challenged in Fiji, irrespective of whether the accountant's judgments has been exercised to facilitate or inhibit it.

III. METHODOLOGY

Earnings management has been empirically investigated in many studies (Phillips *et al.*, 2003; Beneish and Vargus, 2002; Bartov *et al.* 2000; Natarajan, 1999 and Dechow *et al.*, 1995)². The empirical models are not applicable to Fiji's environment due to the lack of quality and consistent data. Therefore, this paper employs a qualitative approach. The checklists developed by Mulford and Comiskey (2002) provide a useful and practical classification scheme to do so without employing empirical modeling. They argue that such a scheme assists the financial report readers to be more focused in their search for items that may indicate that the reported results may not be true. Mulford and Comiskey provide the following categories to detect earnings management: recognising premature or fictitious revenue, capitalisation and amortisation policies, misreported assets and liabilities and using operating cash flow to detect earnings management. Based on these categories, they prescribe a guideline in the form of checklists. The checklists, constructed after considering the international collapse of a number of organisations, provide a list of items that should be considered in detecting earnings management. These checklists are briefly discussed below.

Checklist 1 is based on recognising premature or fictitious revenue. In order to identify possible manipulations, one needs to understand the entity's revenue recognition policy and analyse the physical capacity of the entity as this could indicate whether the entity has the capacity to generate the reported revenue. Generally, with fictitious or premature revenue, there would be no associated cash inflow. Accordingly, a balance sheet account is increased and an obvious one is accounts receivable. Therefore, one also needs to be mindful of unusual increases in accounts receivable as these accompany questionable revenue. Checklist 2 focuses on capitalisation and amortisation/depreciation policies. Some useful analytical tools that could identify improper capitalisation policies include reviewing the entity's capitalisation policy, considering what the capitalised costs represent and analysing whether the entity has adopted improper capitalisation policy in the past. In order to detect manipulations through amortisation and depreciation policies, one can calculate average amortisation period for the entity's depreciable asset base and search for extended amortisation periods in prior years as entities found to be behaving as such in the past are likely to leave themselves open to such problems in future as well.

Checklist 3 identifies misreported assets and liabilities as these have direct links with earnings. The first part of the checklist analyses assets that are not subject to annual amortisation/depreciation, such as accounts receivable and inventory. The second part examines liabilities such as accrued expenses and accounts payable. To identify misreported accrued expenses, it is important to carefully review the trends in such accounts. The fourth checklist deals with how the cash flow from the operating activities could be used to detect earnings management practices. It is generally agreed that operating cash flow is a key indicator of the entity's ability to generate sustainable cash. Managing reported earnings do not change operating cash flow therefore examining the relationship between them is helpful.

² Dechow *et al.* (1995) and Bartov *et al.* (2000) provide a detailed discussion of these models.

These checklists would identify any unexplained, unusual behaviour, which would then be analysed on a case-by-case basis. Analysis will involve checking whether the item is consistent with generally accepted accounting practices and if it was motivated by any incentives. This method assists in identifying the specific accruals used to manage earnings, which cannot be obtained using the accruals models as it aggregates the effects of all accruals.

Given the qualitative approach employed in this study, it is important that more than one case is used so that the applicability of the approach can be tested. However, knowing that a case study requires an in-depth examination of the chosen organization, a large number of cases would become unmanageable and beyond the scope of this study. In light of these factors, two cases are used in this study. The required data are primarily collected from the published annual reports of the entities. Many of the SOEs do not produce annual reports every year but only prepare financial statements. While this is sufficient for empirical models, the qualitative approach requires the financial data together with the narrative information in annual reports. Hence, to be included in the sample, the entities should publish their annual reports periodically. Furthermore, the investigation period is 1990 to 2004 as it is believed that the time frame is large enough to furnish the necessary materials that would be needed to undertake this study. Therefore, the entities selected should be in operation over this period. Of the 16 SOEs in Fiji, only four meet these criteria - the Fiji Electricity Authority, Housing Authority, Public Rental Board and the Unit Trust of Fiji. As only two entities are needed, the two largest entities (in terms of total assets and turnover) are chosen- the Housing Authority and the Fiji Electricity Authority³.

IV. RESULTS AND ANALYSIS

Capitalisation of research and development costs, training costs and administration expenses

The FEA capitalised research and development costs (R&D) over the years 1985 to 1992. FAS 9 Accounting for Research and Development Activities allows an entity to capitalise development costs only and not the costs incurred for undertaking research activities. Therefore, it is important to ascertain whether the capitalisations made by the FEA relate only to development costs or it includes costs incurred for research activities. Although it is not mandatory, FAS 9 considers it useful that entities provide a general description of the research and development project. However, the FEA's annual reports failed to do so and made it hard to verify for which product (or process) the research and development project was undertaken. Further, R&D prior to 1985 was not separately listed in the financial statement, but was aggregated with capital works in progress. It is impossible to disaggregate the figures for R&D from capital works as the way the information is presented does not permit to do so. Hence, the initial capitalisation of R&D is unknown. A review of the capital works that were in progress in 1984 revealed that one of the items listed was *Investigation*. An item termed as *Investigation* seems more likely to be the costs undertaken for research activities.

³The HA was established in 1955 under the *Housing Act* to provide affordable housing to the middle and low-income earners. The FEA was established under the provisions of the *Electricity Act 1966* to provide and maintain a power supply that is financially viable, economically sound and consistent with the required standards of safety, security and quality.

Moreover, the review of the FEA's individual capital works revealed that all assets have long economic lives, ranging from 20-80 years. Hence, if the capitalised R&D includes development costs, it should have been amortised for at least 20 years. Table 1 shows that this is not the case. There had been nominal capitalisations of R&D from 1987 and large write offs. It is also noted that prior to 1987, annual capitalisations exceeded write-offs. The write offs seem to be discretionary, rather than based on any policy. Following a review in 1992, the FEA expensed the remaining balance of R&D. There has been no further research and development expenditure reported in FEA's financial accounts. The analysis so far suggests that the capitalised R&D did include costs incurred for research activities.

During the same periods, FEA also capitalised training expenses. These expenses were initially treated as part of capital works in progress in 1983 while from the following year, it were separately reported as an intangible asset. The following policy note was provided in its annual reports:

During the construction of Monasavu Hydro Scheme \$3,787,769 of training expenses was capitalised, giving rise to an intangible asset in the books of the Authority. This intangible asset is being amortised over 5 years. (The FEA Annual Reports, 1984 - 1987).

Even though the FEA had adopted a policy of amortising training expenses over five years, the expenses were fully amortised in the fourth year. The Authority justified this on the grounds that the benefit from capitalising training expenses was fully realised in the fourth year. This is purely an act of management judgment, which would be difficult to question. The large write off of training expenses in 1987 was accompanied with a first time significant net write off of R&D. The year's annual report was reviewed to find out the reason(s) for the large write-offs of R&D and training expenditure. Apart from the suspension of capital works (which may explain the large write off of R&D), there was no other relevant information provided, which could explain them. It should be noted that 1987 was an opportune year for the FEA to write off unwanted debits it has treated as assets. As a result of political coups and devaluations, the readers would have expected substantial losses during the year and may not be expected to question possible manipulations in intangibles. Non-compliance with generally accepted accounting practices does not necessarily constitute earnings management. It could be possible that the accountants lacked understanding of the requirements of the accounting regulation on this aspect therefore, making this a genuine case. However, one cannot overlook the possibility of opportunistic behaviour. Therefore, it is important to determine if there was any incentive for deferring these costs.

As part of the terms and conditions of the loans, the lending agencies required the FEA to provide 8% return on currently valued fixed assets (the FEA Annual Report 1984). Table 1 depicts the return that the FEA was able to achieve by deferring the recognition of research and training costs. The second last column shows that although in the 1980s (except for 1984) the FEA was not able to achieve the required 8% return but was close to this value. The last column of calculates the returns that would have been achieved had these costs not been capitalised. As expected, there is a noticeable effect in 1983, as this was the year when training expenses were first capitalised. The return on fixed assets after capitalising training expenses yields 7.27%. Had this cost not been deferred, the returns would have been 1.97%. In both cases, the covenant is violated but the return without capitalisation is substantially lower than the required return.

Therefore, it can be argued that research and training expenses were capitalised either to meet or smooth the return on fixed assets.

TABLE 1 EFFECT OF COST CAPITALISATIONS ON RETURN ON FIXED ASSETS

Year	R&D capitalised (amortised) \$000	Training Exp capitalised (amortised) \$000	Profit with Capitalisation \$000	Profit without capitalisation \$000	Return with capitalisations %	Return without capitalisations %
1983		3788	5198	1410	7.27	1.97
1984	3418	(758)	21290	18630	11.98	10.48
1985	628	(757)	21223	21352	5.8	5.84
1986	85	(758)	27774	28447	6.17	6.37
1987	(1216)	(1516)	31519	34251	6.53	7.27
1988	(138)		9669	9807	7.74	7.77
1989	(5)		29736	29741	7.35	7.35
1990	(442)		34352	34794	7.21	7.30
1991	(365)		40179	40544	8.01	8.08
1992	(1965)		40050	42015	8.1	8.50

(Adapted from the FEA Annual Reports 1983 -1992)

Studies have shown that debt covenants are one of the strongest incentives for earnings management in the private sector. Accordingly, one might argue that as FEA's debts are guaranteed by the government, observing the terms of a debt covenant cannot be an incentive for manipulation of profits. It cannot be denied that the presence of government guarantees weakens this incentive in FEA. However, it can also be argued that government as a guarantor can pressure FEA to satisfy the covenants. Therefore, in FEA's case, the pressure to report certain numbers in the financial reports comes more from the government than meeting the lenders terms. There are occasions where the FEA has been penalized for not meeting the covenants. The penalties were in the form of government declining to guarantee further debts and lenders not allowing the raising of further long- term funds.

Similarly, the HA capitalised indirect administrative costs to work-in-progress inventory. According to FAS 11 Accounting for Construction Contracts, general administration costs are *usually* excluded from accumulated contract costs because they do not relate to reaching the present stage of completion of a specific contract. However, *in some circumstances*, these costs are specifically attributable to a particular contract and are *sometimes* capitalised. Since the accounting regulation permits the capitalisation of administrative expenses in certain circumstances, if an entity is capitalising this expenditure, it is *possible* that they are attempting to boost current period earnings. Consequently, it may be *possible* that the HA interpreted this to suit its own convenience rather than to generally reflect economic reality! Capitalising administrative expenses to work-in-progress has two effects on profits. First, when the costs are capitalised, the current period earnings will increase. Second, these capitalised costs will be expensed when the work-in-progress inventory is completed and sold, upon which, it will be

expensed through cost of sales. Thus, in the subsequent periods, cost of sales will increase leading to a reduction in earnings. It took HA an average of two years to complete individual projects and sell them off. Table 2 depicts the profits that were reported after capitalisation and the profits that would have been reported if the HA had not capitalised these expenses.

TABLE 2 EFFECTS OF CAPITALISING ADMINISTRATIVE COSTS ON PROFITS

Year	Profits with capitalisation		Capitalised administrative costs (\$000s)	Reversal effects - Profits without capitalisation		
	Net Profit \$000s	NP/Equity (%)		Subtract capitalised costs from profits \$000s	Add back cost of sales to profits \$000s	NP/Equity (%)
1989	(4088)	(151.86)	86	(4088) - 86 = (4174)	(4174)	(155.05)
1990	(1141)	(67.04)	76	(1141) - 76 = (1217)	(1217)	(71.50)
1991	(1898)	(236.07)	415	(1898) - 415 = (2313)	(2313) + 86 = (2227)	(276.99)
1992	248	12.09	576	248 - 576 = (328)	(328) + 76 = (252)	(12.28)
1993	518	12.02	575	518 - 575 = (57)	(57) + 415 = 358	8.30
1994	687	11.81	676	687 - 676 = 11	11 + 576 = 587	10.09

(Adapted from the HA Annual Reports 1989–1994 and author's calculations)

The effect of capitalisation was more observable in periods 1992 to 1994⁴. Capitalisation improved the profitability position from a negative return on equity of 12.28% to positive 12.09% in 1992. Further, in 1993 and 1994, it increased the returns from 8.30% to 12.02% and 10.09% to 11.81%, respectively. Given that capitalisation increased profits, the following section examines if there was any incentive(s) for reporting higher earnings during these years.

The new government that came in power in 1992 emphasised on public sector reforms as a means of bringing efficiency in the operations of SOEs. In line with the government's reform agenda, the HA's focus changed as it prepared for privatisation. The Authority began to pursue commercial activities with a view of making profit. Taking into account the changes that took place in the government, it could be argued that the newly elected government wanted to reflect its performance through the performance of the HA. Furthermore, there were major changes in the HA's Board membership in 1993 as four out of the six board members were replaced during the year. Thus, the incentive to report high profits in 1993 may have also originated from the HA's Board. Additionally, the HA introduced performance based contracts at the senior executive level in mid 1993. All staff in these positions was put on three-year contract and the renewal of their contracts and annual bonuses were based on the achievement of the set targets. Performance indicators, comprising of both financial and non-financial, were used as a measure of the achievement of the targets. When the targets are not achieved, a review is carried out to determine the underlying reasons. After a thorough investigation, the targets are reviewed or reduced so that they are attainable. Performance based contracts provided incentives to manage

⁴ Capitalised administrative expenses were not explicitly reported prior to 1989 as the format in the presentation of information had changed. Also, this amount was not reported in the financial statements from 1995 so the table could not be extended beyond 1994.

earnings upwards in order to qualify for annual bonuses and continuity of employment. However, it is difficult to clearly establish the link between the targets and performance given that in some instances where the targets were not achieved, they were reduced.

Provision for Doubtful Debts

In 1999 the HA changed its accounting policy for provision for doubtful debts by changing the definition of non-performing loans. Prior to this, a non performing loan was classified as one on which interest was in arrears for six months or more. From 1999 this was reduced to three months. This change increased the non-performing loans portfolio by approximately \$24.40 million. Once a loan is deemed to be non-performing, interest revenue will cease to be recognised on them. Thus, the Authority lost about \$2.60 million of interest revenue. Given that non-performing loans have increased, so will its related provision for doubtful debts. The HA justified that the revision in policy conformed to commercial and international practices.

The policy change was in line with the requirements of FAS 30 Additional Disclosure by Financial Institutions. The standard does state the 90-day threshold period for classifying loans as non-performing. Hence, the change is not questionable. However, one cannot overlook the possibility that the HA could have exaggerated the effects of the policy change. Excessive provisioning often leads to write-back in subsequent years. Upon reviewing the financial accounts, no such write-backs were found. Alternatively, there would be reduced provisioning in the future periods. Table 3 shows the provision for doubtful debts over the years as reported in the Income Statement. Given that from 1999, loans were classified as non-performing three months sooner, it is expected that the doubtful debts should be more than what was provided for prior to the change. The values in the table show otherwise. The provisions after the change is relatively lower than the previous years' provisions. One could argue that the HA may have taken steps to reduce the non-performing loans and hence its provisions. However, there is no evidence of such measures being implemented by the HA.

TABLE 3 DISCRETIONARY EXPENDITURE

Year	Provision for Doubtful Debts		Stock Write down		Net profit	
	\$000s	% of Receivables	\$000s	% of Stock	\$000s	% of Assets
1995	3522	2.84	163	0.75	(2393)	(1.43)
1996	3302	2.49	977	5.26	(5695)	(3.37)
1997	1542	1.18	170	0.95	115	0.07
1998	1421	1.00	130	1.34	160	0.10
1999	5836	4.09	777	12.90	(3400)	(2.15)
2000	1993	1.41	0	0.00	(432)	(0.27)
2001	783	0.54	355	9.49	518	0.31
2002	870	0.54	287	7.56	538	0.31
2003	968	0.64	41	0.59	771	0.43
2004	1365	0.96	250	2.18	2067	1.30

(Adapted from the HA Annual Report 1992-2004 and author's calculations)

Furthermore, the Chairman stated that the operating loss was inevitable due to changes in accounting policies for both, provision for doubtful debts and stock-write downs. Although the change for provision for doubtful debts was explained, no explanation was given for the change in stock write-downs. Yet, a perusal of the expenses reflects a major movement in the account balance from the previous year as shown in Table 3. The table shows that apart from major increase in the provision for doubtful debts in 1999, stock write-downs represented 13% of stock, being the largest over the review period. Thus, the trend in the provision for doubtful debts and the stock write-down in 1999 supports the argument that the HA may have increased the provisions.

A possible incentive could be the need to convert the \$44 million ADB and World Bank debts into equity. From as early as 1999, the HA had commenced discussions and made submissions seeking government approval for the conversion. The change in accounting policy in 1999 had worsened the profitability of the HA and consequently deteriorated the equity balance. Eventually in October 2002, the Parliament approved to convert these loans into government equity. This moved the HA's negative equity position of \$3.8 million in 2001 to a positive \$38 million in 2002. Table 4 demonstrates the effects of changing the accounting policy in 1999. As it is argued that the HA may have exaggerated the effects, the table also takes into account the large increase in stock write down.

TABLE 4 EFFECTS OF CHANGE IN ACCOUNTING POLICY AT THE HA IN 1999

	Change in Accounting policy		No Change in Accounting policy	
	\$000s	% of Assets	\$000s	% of Assets
Interest income	13893	8.79	13893 + 2600 = 16493	10.43
Profit before abnormal items	(1416)	(0.90)	(1416) + 2600 + 777 = 1961	1.24
Abnormal items	(1984)	(1.26)	(1984) - 4291 = 2307	1.46
Profit after abnormal items	(3400)	(2.15)	1961 + 2307 = 4268	2.70
Accumulated profits	(24102)	(15.25)	(20702) ⁵ + 4268 = (16434)	(10.40)
Equity	(5344)	(3.38)	(5344) - (24102) + (16434) = 2324	1.47

(Adapted from the HA Annual Report 1999 and author's calculations)

With the change in the definition of non-performing loans, the HA lost about \$2.60 million of interest income. Hence, if the change was not made, the HA would have earned \$16.49 million of interest income. Adding back the \$0.78 million of stock write down to income yields an operating profit before abnormal items of \$1.96 million. In order to determine the profit after abnormal items, the provision for doubtful debts of \$2.31 million is added back to yield \$4.27 million. Thus, the table shows that presently the return on assets is negative 2.15%. If the policy were not revised, it would have been positive 2.70%. Additionally, after the change in accounting policy the equity position deteriorated to a negative 3.38% from positive 1.47%. The negative equity position was the major concern that the HA was indeed using when making

⁵ This is the beginning balance for accumulated profits

requests to the government to convert the debts into equity. Had the accounting policy not changed, it would be less likely that the government would agree to the conversion. The table shows that if the HA had not changed its accounting policy; it would have made an operating profit of \$4.27 million. This profit would have been achieved despite that HA had reduced its lending rate. A high reported profit is politically unacceptable in view of the Authority's social objective. Therefore, the HA may not want to report high profits irrespective of government policy and management incentive schemes. This proves to be another incentive for exaggerating the effects of accounting policy change and reporting a loss in 1999.

Revaluation & Classification of government grants

The FEA revalued its fixed assets in 1992 and adopted a policy of revaluing assets every five years. The revaluation resulted in an increase in the value of fixed assets by \$164.08 million and a consequential increase in depreciation of \$3.39 million during the year. The revaluation exercise significantly improved the FEA's equity position in 1992 from \$43.68 million without revaluation to \$204.37 million, representing an increase of almost 370%. Further, the higher equity balance helped FEA to reduce the debt to equity ratios. Total debt to equity ratio fell from 7:1 to 1:1 and long-term debt to equity ratio also moved in the similar manner from 5:1 to 1:1. According to the General Manager Finance the revaluation exercise aligned FEA's debt to equity ratios to a commercially acceptable level and within the guidelines set by the offshore financiers.⁶ Even though most of the FEA's indebtedness is guaranteed by the government, it still has to meet the covenants set by the lending agencies. The offshore lending agencies required the Authority to maintain a debt to equity ratio of 3:1 (The FEA Annual Report, 1984). The devaluations of 1987 resulted in \$99.17 million of unrealized foreign exchange losses, which consequently eroded the equity position of the Authority through accumulated losses. Since then, the equity position of the FEA had been negative and it was unable to meet the debt to equity covenant. Although, capital contributions were made by the government, they were insufficient to offset the deteriorated equity balance. The revaluation exercise not only improved the equity balance but also assisted the FEA to meet the covenant of 3:1 debt to equity ratio.

The next valuation was to be undertaken in 1997 but was deferred due to the Authority's anticipated corporatisation. Despite the FEA's policy, it has never undertaken a revaluation exercise in the past 12 years since 1992. It is worth noting that reporting entities in Fiji generally face real problems in revaluing assets as it is a costly exercise. The deferral of subsequent valuation and the associated costs of revaluation further supports the argument that the revaluation in 1992 was undertaken with an opportunistic intent. This argument is further strengthened by the following section on the classification of government grants.

Government grants of the FEA represent the fair value of non-monetary assets received from the overseas government. From 1995, grants also include cash contributions. The FEA reported grants as part of equity for years prior to 1995 while from the following year it was reported as a non-current liability. This reflects inconsistency in reporting government grants. Alternatively, the nature of the grants may have changed from 1995 hence the differing treatments. Apart from

⁶ During these periods offshore loans were around 50% of total borrowings.

the above described fact about the FEA's grants, there was no information disclosed in the annual reports suggesting that the nature of grants had changed. Also, the accounting policies relating to government grants during the concerned periods remained unchanged. Given the inconsistency in the classification and the absence of any explanation to prove otherwise, it is important to ascertain which of the two classifications is correct. According to FAS (IAS) 20⁷ Accounting for Government Grants and the Disclosure of Government Assistance, grants can be accounted for using either the capital or income approach. As the FEA receives non-monetary, FAS 20 requires these grants to be accounted for using the income approach and should either be presented as liability or deducted from the carrying amount of the asset. Thus, FEA's treatment from 1995 is correct while in the earlier years it resulted in non-compliance with FAS 20. As mentioned earlier, non-compliance with accounting standards does not always constitute earnings management. It could be possible that the FEA made a genuine error in classifying government grants. It is worth pointing out that the misclassification did not occur in a single but a series of years. With due respect, the auditors should have been able to spot this error. Their failure to do so suggest either the audit team was lax or they "condoned" the accounting treatment. Also, during the years of misclassification, the same firm audited their accounts and the correct approach was applied when there was a change in their auditor. In light of this, the FEA's misclassification seems more to be opportunistic rather than a general error in practice. This undoubtedly seems to be a case where the FEA has stretched the limits of generally accepted accounting practices to the extent that it actually led to non-compliance. It should, however, be noted that the misclassifications did not affect profits as in both the treatments, grants were amortised. As with the revaluation exercise, the misclassification of grants improved the equity balance and the debt to equity ratios of FEA. Table 5 shows the combined effects of these events.⁸

TABLE 5 COMBINED EFFECTS OF REVALUATION AND CLASSIFICATION OF DEFERRED INCOME

Year	Scenario 1 : No Revaluation and Deferred Income is Reported as Liability		Scenario 2 : No Revaluation and Deferred Income is Reported as Equity		Scenario 3 : Revaluation and Deferred Income is Reported as Equity	
	Total Debts to Equity	Long-Term Debts to Equity	Total Debts to Equity	Long-Term Debts to Equity	Total Debts to Equity	Long-Term Debts to Equity
1989	(44.13)	(33.39)	(58.36)	(44.07)	(58.36)	(44.07)
1990	(58.77)	(41.53)	(86.87)	(61.25)	(86.87)	(61.25)
1991	39.18	29.42	24.52	18.32	24.52	18.32
1992	10.05	7.38	6.99	5.07	1.49	1.08

(Adapted from the FEA Annual Report 1990-1992 and author's calculations)

In 1989 and 1990, the FEA had a negative equity position hence the debt to equity ratios in these years are not meaningful. The difference in the ratios is more observable in the remaining years.

⁷ FAS 20 was issued in 1992 and was identical to IAS 20. In the absence of any national accounting standards on government grants prior to 1992, the FEA relied on IAS 20.

⁸ Given that revaluation increased depreciation expense in the current as well as in the subsequent years, the extent of the increase in depreciation expense in subsequent years is hard to determine. Thus it was impossible to extend the table beyond 1992.

In scenario 1 with no revaluation and deferred income correctly reported as a liability, the total debt to equity ratio and long-term debt to equity ratio was the highest of all the three scenarios. By reporting deferred income as equity, the FEA was able to reduce the ratios in scenario 2. Although, the ratio was reduced, it was still high when compared with industry standards and those set by the overseas lenders. Hence, the revaluation exercise in the third scenario produced the lowest debt to equity ratios, which were now within the industry and overseas lenders' standards. The combined analysis illustrates that the FEA had intended to reflect an improved debt to equity ratios. This was initially achieved by classifying deferred income as equity and the subsequent revaluation activity further strengthened the financial position. Hence, the revaluation and the misclassification of government grants clearly represent a case of earnings management at the FEA.

Depreciation rates

The FEA began to apply tax depreciation rates from 1999, which were higher than the previously applied rates. The depreciation rates were changed for the new assets as well as those acquired prior to 1999. As a result, depreciation expense increased by \$21.16 million during the year. As changing depreciation rates have on-going effects, the FEA has managed to increase its depreciation expenses in the future periods as well. The following table illustrates the Authority's depreciation expenses and its impact on profits.

TABLE 6 DEPRECIATION EXPENSES AND PROFITS OF THE FEA

Year	Depreciation		Total Expenses		Profit		If the rates were not changed	
	\$000s	% of PPE	\$000s	% of Income	\$000s	% of Assets	Depreciation \$000s	Profit \$000s
1992	9263	1.87	36907	68.29	17294	3.39		
1993	13671	2.64	39636	68.75	18189	3.53		
1994	14118	2.68	45260	73.80	16379	3.21		
1995	14309	2.66	48343	70.97	20470	3.92		
1996	14484	2.67	56116	78.20	17320	3.29		
1997	14538	2.64	55605	76.60	18408	3.68		
1998	14391	2.56	63472	74.91	21256	4.27		
1999	36095	6.31	83378	90.23	9028	1.87	14467	30656
2000	35733	6.22	93694	107.64	(6647)	(1.40)	14535	14551
2001	35902	6.03	97971	99.97	31	0.01	15056	20877
2002	41030	6.39	110886	96.70	3787	0.83	16257	28560
2003	43301	6.52	125204	97.96	2609	0.57	16791	29119
2004	20260	3.02	119449	92.77	9306	2.06	16970	12596

(Adapted from the FEA Annual Reports 1992-2004)

The profits to assets ratio reduced to 1.87% in 1999 compared to 4.27% in the preceding year and the FEA attributed this to the change in depreciation rates. Table 6 also illustrates the depreciation expenses and profits that would have been reported if the rates were not changed. It is evident from the table that the change has significantly affected profits. The FEA changed

depreciation rates for two reasons- prudence and its taxable status. According to FAS 1 Disclosure of Accounting Policies, prudence is one of the factors that govern the selection and application of accounting policies. The FEA asserts that by employing tax depreciation rates, it would be able to reflect a more realistic life of its fixed assets. This reason seems to be justifiable as long as the FEA had not used it for the purpose of creating hidden reserves. Nonetheless, it should be noted that tax depreciation rates are arbitrary and apply to certain types of assets rather than to industries. It is impossible for tax depreciation rates to fairly reflect the economically useful life of an asset as they are often structured to provide investment incentives. Further, being a taxable entity does not oblige it to adopt depreciation rates used by the tax authorities; it can still employ the accounting rates. Hence the FEA's reason to adopt tax depreciation rates due to its taxable status seems to be neither necessary nor justifiable. This change is analysed together with the changes made to the capitalisation policies as described below.

From January 1994, the FEA expensed certain overheads, which could not reasonably be identified as forming part of the cost of purchase or acquisition of an asset or of bringing it to its working condition. These overheads were previously capitalised to property, plant and equipment. From 1996, the FEA ceased to capitalise administrative salaries and motor vehicle operating costs to the acquisition cost of property, plant and equipment. The FEA stated that by expensing these costs from 1996, they were able to reflect actual operating expenditure. It should be noted that neither of the two changes was done retrospectively. The changes increased the FEA's operating expenses by \$0.90 million and \$2.50 million in 1994 and 1996, respectively. These are reflected in Table 6. In 1994, the operating expenses represented 74% of income and in 1996 it increased to 78%. Higher operating expenses reduced FEA's profits during the concerned periods.

According to FAS 16 Accounting for Property, Plant and Equipment, the capitalisation of administration and other general overhead expenses is dependent on whether these expenses were related to the assets acquisition or bringing it to its working condition. The FEA used this condition to justify their policy change by stating that these costs are expensed as these are not specifically related to the assets acquisition. On the surface, it seems that the policy change was made to reflect economic reality. Knowing that the determination of whether an expenditure is an asset or an expense can have a significant effect on the entity's operating results, it could also be possible that the policy change was an attempt of earnings management. The increase in depreciation rates and changes in capitalisation policies seem to be related. As a result of all the three changes, the FEA's expenses (depreciation and operating) increased resulting in reduced profitability. There were motives for the FEA to report reduced earnings during these periods.

The FEA was involved in a long running debate with the government over their tax status. Since inception it has been exempted from tax but the Income Tax (Amendment) Decree repealed the FEA's tax exempt status from 1 July 1992. The FEA made submissions to the appropriate Ministries for an extension of the tax exempt status, back dating from 1 July 1992 to 31 December 1996. Thus, the FEA did not adopt tax effect accounting and had not provided for any taxes payable on its profits during these periods. If the FEA's submissions had not been accepted,

its tax payable from 1 July 1992 to 31 December 1996 would have been expected to be \$23 million (Parliamentary Debates, 2005). The FEA argued that its operational costs made it difficult to cope with the universal service obligations that they are undertaking⁹. The cost of these services is an average of \$25 million annually. Although the Public Enterprise Act requires the government to reimburse the universal service obligation costs to the FEA, such costs have not been refunded. The Authority argues that it was able to afford these obligations in the past when it was exempted from paying tax and dividends to the government. Further, the FEA as a commercial statutory authority is required to earn the government a target return on equity of 10% from 2002. The FEA's Board Chairman asserted that as long as the government reimburses these costs, the Authority could earn the benchmark return. In September 2002 the Cabinet finally decided to extend the FEA's tax exempt status from 1 July 1992 to 31 December 1996. It was also decided that the FEA's universal service obligation be recognised as its annual 'social' dividend to the government.

The above discussion highlights that the FEA sought to extend its tax exempt status and reimbursement of universal service obligations costs. An entity with marginal or reduced profitability has a high chance of getting a favorable response in contrast to an entity with a series of high reported profits. The changes made to the capitalisation policies in 1994 and 1996 have led to a continuous reduction in earnings. The increase in the depreciation rates from 1999 further reduced profitability. Therefore, the analysis indicates that the changes to the accounting policies were used as an earnings management device since the changes have undoubtedly assisted the FEA to make a permissible case to the government.

V. CONCLUSIONS AND LIMITATIONS

Earnings management practices erode the quality of financial reporting as it is used to manipulate the true and fair view of the entity's performances. Earnings management issues are widely researched in the developed countries. Conversely, studies in developing countries are rare. Therefore, this paper analyses the possibilities of earnings management practices in two SOEs of Fiji over the period 1990 to 2004. The results illustrate that the key accounting areas used by the two entities for these practices were provisions, amortisation and depreciation rates, capitalisation policies, revaluations and classification of government grants. All these practices were within the boundaries of generally accepted accounting practices except for the classification of grants and capitalisations of research and training expenses. Overall, the findings are consistent with *a priori* expectation that in the presence of agency relationships and flexibility in accounting standards, earnings management practices will exist. However, these observations should be interpreted in light of the following limitations.

Earnings management practices are normally examined using empirical models, which require large samples of data. In Fiji, the limited number of reporting entities does not permit the application of the widely used statistical models. Therefore, the study pursued with a qualitative

⁹ As a universal service obligation, the FEA subsidises power to certain areas of the country.

case study method of investigation. While empirical models objectively determine the presence of earnings management, results from the qualitative approach are subjective to the interpretation of data. Given the methodology applied, it could be possible that the study may have been unable to identify all instances of earnings management in the two entities, particularly those which were more creatively practiced. Moreover, the entities examined are government owned, where the public is privy to certain documents/data. If these were made available, it would have added more validity to the findings of this study. Nonetheless, it should be noted that this is a pioneering attempt and can be used as a guideline by other researchers who may explore earnings management practices in countries where the accruals models are inapplicable.

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